ALERT MEMORANDUM

SEC Releases Enforcement Division FY 2017 Annual Report: Shift in Tone and Likely Approach

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If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

WASHINGTON

Matthew C. Solomon
+1 202 974 1680
msolomon@cgsh.com

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

Alexis Collins
+1 202 974 1519
alcollins@cgsh.com

On November 15, 2017, the Securities and Exchange Commission Division of Enforcement released its annual report detailing its priorities for the coming year and evaluating enforcement actions that occurred during Fiscal Year ("FY") 2017.[1] The Report captures the SEC during a period of transition—Chairman Jay Clayton assumed the helm of the Commission in May 2017[2] and Stephanie Avakian and Steven Peikin were named co-directors of the Enforcement Division soon thereafter.[3] The Report provides insight into changes in the SEC's approach to enforcement actions and a glimpse into its priorities for the coming year. The following summarizes key shifts from FY 2016, outlines the Enforcement Division's current priorities, and, in view of its stated focus on the conduct of investment professionals and protection of retail investors, provides guidance to the investment management industry as it gears up for the coming year.

[1] U.S. Securities and Exchange Commission Division of Enforcement, "Annual Report: A Look Back at Fiscal Year 2017," available at https://www.sec.gov/files/enforcement-annual-report-2017.pdf (the "Report").
[2] U.S. Securities and Exchange Commission Press Release, "Jay Clayton Sworn in as Chairman of SEC" (May 4, 2017), available at https://www.sec.gov/news/press-release/2017-94.
[3] U.S. Securities and Exchange Commission Press Release, "SEC Names Stephanie Avakian and Steven Peikin as Co-Directors of Enforcement" (June 8, 2017), available at https://www.sec.gov/news/press-release/2017-113.

1. **FY 2017 by the Numbers**

The Report's statistics for FY 2017 reveal a surprisingly active Enforcement Division in view of the transition, which continues to focus on issuer reporting/accounting and auditing, securities offerings, and investment management issues, with a growing emphasis on individual accountability. The Report's focus on the effective allocation of resources "to address the most significant market risks" and its emphasis on sanctions "that will be most appropriate in the matter at hand" reflect a general shift in tone and suggest a more measured approach to enforcement and remedies going forward.[4] Notably, while the Report makes use of statistics in assessing FY 2017, it also signals a clear move away from "a statistics-oriented approach" and propounds the view that statistics only "provide a limited picture of the quality, nature, and effectiveness of [the Enforcement Division's] efforts."[5] Below are a few observations based on the metrics in the Report.

— **Enforcement Remained Relatively Strong Despite Transition**:[6] In spite of changes in leadership, the number of enforcement actions in FY 2017 remained fairly strong. While the total number of standalone enforcement actions in FY 2017 dipped from 548 in FY 2016 to 446, marking a 19% decline in absolute terms, the SEC attributes this decline to the conclusion of the Commission's Municipalities Continuing Disclosure Cooperation ("MCDC") initiative, a "voluntary self-reporting program that targeted material misstatements and omissions in municipal bond offering documents." The Report credibly points out that removing the 84 actions connected to the MCDC from FY 2016 numbers results in a much smaller 4% decrease in actions over the previous year.

— **Penalties Declined as Disgorgement Remained Steady**:[7] Total penalties imposed in FY 2017 declined from over $1.2 billion in FY 2016 to $832 million—a fall of nearly 35%. Although the SEC's ability to collect disgorgements as a penalty may be more limited going forward after *Kokesh*,[8] total disgorgement increased in FY 2017 by a moderate 5% to approximately $2.95 billion. The overall monetary relief ordered by the Commission declined 7% from FY 2016 to approximately $3.8 billion.

— **Record Highs in Distributions to Harmed Investors**:[9] By contrast, in FY 2017, the SEC distributed a record $1.07 billion to harmed investors—a substantial increase from $140 million in FY 2016. An overwhelming portion of these distributions ($814 million) came from four Fair Funds, including a $494 million distribution from the CR Intrinsic Investors fund. As the Report acknowledges, however, many of these distributions derive from actions in previous years.

— **Few Changes in Types of Actions Brought**:[10] If MCDC actions are excluded from FY 2016 numbers, the type of actions the SEC pursued in FY 2017 appeared relatively steady. Other than a sharp decline in public finance abuse cases because of the end of MCDC, no category's share of overall actions shifted by more than 3 percentage points from FY 2016, as a percentage of total enforcement actions. While the total number of actions involving investment advisers and investment companies decreased somewhat from 98 actions in FY 2016 to 82, the share of actions involving those issues in FY 2017 decreased from 21% to 18% (excluding MCDC actions). Securities offering and issuer reporting cases comprised a greater proportion of FY 2017 numbers, though both types of actions represented

[4] *See* Report at 2-3.
[5] *See id.* at 3.
[6] *See id.* at 6.
[7] *See id.* at 7-8.
[8] *Kokesh v. S.E.C.*, 137 S. Ct. 1635, 198 L. Ed. 2d 86 (2017) (holding that disgorgement operates as a penalty for purposes of the five-year limit on enforcement penalties under 28 U.S.C. § 2462).
[9] *See id.* at 11.
[10] *See id.* at 15.

two of the top three areas of enforcement in both FY 2016 and FY 2017. FCPA was one area that showed a marked drop-off year-over-year: the total number of FCPA actions significantly declined in FY 2017, with only 13 FCPA actions brought in FY 2017 as opposed to 21 the prior year.

— **Steady Focus on Individual Culpability**:[11] 73% of standalone actions in FY 2017 included charges against individuals. When excluding MCDC actions from FY 2016 numbers, this suggests a flat trajectory. The Report emphasizes, however, that individuals have been charged in over 80% of standalone actions brought since Chairman Clayton took office, suggesting strongly that individual accountability will continue to be a major enforcement focus.

— **Trading Suspensions Surged as SEC Tailors Remedies**:[12] A guiding principle of the current Commission is tailoring sanctions to the matter at hand. To this end, the Commission increased the number of trading suspension orders by over 55% compared to last year. Court-ordered asset freezes also slightly increased from 33 freezes in FY 2016 to 35. While bars and suspensions of wrongdoers decreased from 650 to 625, given the overall decline in enforcement actions, these numbers nonetheless reflect a Commission focused on employing the full scope of available remedies.

2. **SEC Priorities for FY 2018**

The Report's identification of "five core principles" guiding the Division's enforcement decisions suggests that the following will be priorities for the Division in the coming year.

— **Protecting Retail Investors**:[13] The Enforcement Division emphasized its focus on misconduct that targets "Main Street." In light of this, the Commission recently formed the Retail Strategy Task Force, which is dedicated to "developing effective strategies and methods to identify potential harm to retail investors." The Enforcement Division is also working closely with the Office of Compliance Inspections and Examinations ("OCIE") to identify vulnerabilities in this area.

— **Combatting Cyber-Related Threats**:[14] The Commission has prioritized ongoing efforts to keep up with rapid technological changes that affect the market. The Enforcement Division recently announced the creation of a Cyber Unit to consolidate the Commission's institutional cyber-expertise. The Unit includes experts in cyber intrusions, distributed ledger technology, and the dark web, and coordinates with other regulatory and criminal authorities.

— **Continued Focus on Individual Culpability**:[15] With the uptick in enforcement actions charging individuals in the six months since Chairman Clayton took office, the Commission has already illustrated its commitment to individual accountability. The Report, however, may foreshadow a drop in overall enforcement actions in FY 2018. A continued focus on individual accountability may make it difficult to move cases against companies through the Enforcement Division without an individual prosecution. Moreover, as the Report acknowledges, significant resources are required for actions against individuals, both in terms of investigative and litigation costs.

— **Tailoring Sanctions to Further Enforcement Goals**:[16] During FY 2018, the Commission will continue to apply a wide range of potential remedies in order to meet enforcement goals. This may portend a drop in total monetary relief awarded as the Commission increasingly relies on non-monetary sanctions.

[11] *See* Report at 2, 11.
[12] *See id*. at 2, 11-12.
[13] *See id*. at 1, 5.
[14] *See id*. at 2, 4-5.
[15] *See id*. at 2, 11.
[16] *See id*. at 2, 11-12

— **Ongoing Assessment of Resource Allocation**:[17] The Enforcement Division has highlighted a need to continually assess the efficiency and efficacy of its current resource allocation and to keep front-of-mind the biggest threats to market integrity. This reflects the Division's general shift away from the broken-windows strategy and "sweeps-type" enforcement actions like the MCDC towards fewer and larger cases. This approach makes sense in view of likely scarce resources in the near- to medium-term.

3. **Guidance for the Asset Management Industry Going Forward**

As those in the asset management industry consider revisions to their policies and procedures for FY 2018, as well as their risk profile more generally, they should keep in mind key insights into the Commission's enforcement strategy offered by the Report.

— **Expect Increased Scrutiny For Misconduct Affecting Retail Investors**:[18] The Commission emphasized that its focus on protecting retail investors is not incompatible with policing Wall Street. The Retail Strategy Task Force will focus in part on misconduct that occurs "at the intersection of investment professionals and retail investor," like recommending higher-cost mutual fund shares to clients, advising investments in volatile products like inverse exchange-traded funds ("ETFs"), and engaging in abusive sales practices like churning and excessive trading.[19] The Report highlights several recent cases targeting these issues: Barclays Capital was ordered to pay $97 million partly because of excessive mutual fund fees earned by recommending higher-cost share classes; Morgan Stanley agreed to pay an $8 million penalty for a single inverse ETF investment that was recommended to advisory clients; and two New York-based brokers were charged for generating commissions by fraudulently using an in-and-out trading strategy.

Investment managers should not expect relaxed enforcement as the Commission's attention focuses on protecting retail investors. Actions against investment advisers and investment companies remain a relatively large share of overall actions, at roughly 20% of total enforcement actions, despite the small downtick in FY 2017. Moreover, most of the cases the Commission highlighted in the Report as directly impacting retail investors involved misconduct by investment managers. The Division should be taken at its word when it says that it will attempt to protect Main Street and police Wall Street simultaneously.

— **Investment Managers are Part of the Commission's Cyber Focus**:[20] The Cyber Unit's stated initial focus includes policing against intrusions into retail brokerage accounts. This concern extends to investment managers, who are required to adopt policies and procedures to protect client information. In recent years, the SEC has charged investment managers for failing to have adequate cyber-policies in place. For example, Morgan Stanley was ordered to pay a $1 million penalty[21] and R.T. Jones Capital settled charges related to failures in protecting consumer information.[22]

In pursuing cyber cases, the Division of Enforcement coordinates closely with OCIE. As the SEC ramps up cyber-enforcement, investment managers can glean insights from a recent OCIE report about cyber-security examinations of

[17] *See id.* at 2-3.
[18] *See id.* at 5, 12-13.
[19] *See id.* at 5.
[20] *See* Report at 2, 4-5.
[21] U.S. Securities and Exchange Commission Press Release, "SEC: Morgan Stanley Failed to Safeguard Customer Data" (June 8, 2016), available at https://www.sec.gov/news/pressrelease/2016-112.html.
[22] U.S. Securities and Exchange Commission Press Release, "SEC Charges Investment Adviser With Failing to Adopt Proper Cybersecurity Policies and Procedures Prior To Breach" (Sept. 22, 2015), available at https://www.sec.gov/news/pressrelease/2015-202.html.

broker-dealers, investment advisers, and investment companies.[23] Investment managers should maintain and enforce detailed cybersecurity-related instructions, regularly test for data integrity and vulnerabilities, establish controls on accessing data, and implement employee training programs on information security.

— **Misrepresentations to Investors Can Result in Significant Penalties**:[24] In FY 2017, the largest penalty ordered by the Commission was against Credit Suisse, when it was ordered to pay a $90 million penalty for misrepresentations associated with valuations in its wealth management business. Investment managers' disclosures should be thorough and accurate to avoid potentially large penalties.

— **The Enforcement Division's Retail Focus Covers a Wide Range of Institutional Actors**: The Enforcement Division's emphasis on protecting retail investors should not be misunderstood as providing safe-haven for asset managers that market to "ultra-sophisticated investors."

The SEC provides its more detailed enforcement report in early 2018, but for now the Report's statistics and newly-announced priorities offer valuable insight into the SEC's enforcement approach. How the Commission's priorities actually play out over the FY 2018 remains to be seen, and are of course subject to market events that can quickly alter the approach midstream. But at least for now the investment management industry—which straddles Main Street and Wall Street—appears front-and-center in the Enforcement Division's current thinking about how it will allocate resources in 2018.[25]

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[23] OCIE National Exam Program Risk Alert, "Observations from Cybersecurity Examinations" (Aug. 7, 2017), available at https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf.

[24] *See* Report at 10.

[25] This Alert Memorandum was prepared with the assistance of Jenny Paul, Molly B. Calkins, and Adam Motiwala.